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USTR FOR KATZ
DEPARTMENT PASS FEDERAL RESERVE SAN FRANCISCO FOR FINEMAN
DEPARTMENT PASS EXIM BANK
DEPARTMENT PASS USTR

E.O. 12598: N/A
TAGS: EFIN EINV ECON PGOV KCOR ID
SUBJECT: INDONESIA'S INSURANCE SECTOR STILL STRUGGLING

¶1. (SBU) Summary. A decade after the financial crisis, Indonesia's small insurance sector continues to suffer from weak regulation and poor enforcement, inadequate training, low professional standards, and insufficient capital. A few players dominate the sector, and some small, non-transparent firms are insolvent. Industry insiders say one of the largest life companies, Bumiputera 1912, with 9.7 million policyholders and $1 billion in assets, is currently operating as a Ponzi scheme with an estimated $500 million in liabilities above its equity. Though in poor financial shape, the domestic industry has been resistant to reform and professional training and certification for insurance underwriters has only recently begun. Weak regulation and fallout from the bogus bankruptcy cases against Manulife and Prudential have made for a treacherous operating environment for foreign firms, and 14 international insurance companies in Indonesia closed their doors from 2000-04. In July 2006, the Government of Indonesia (GOI) and Bank Indonesia launched a policy package aimed at strengthening the banking industry, non-bank institutions and capital markets by resolving insolvent insurance firms, improving the quality and effectiveness of insurance industry regulation, and subjecting insurance company management to fit and proper tests. The World Bank has recommended the GOI resolve weak and bankrupt firms, improve the Ministry of Finance's (MOF) enforcement and regulatory capacity, and launch a sustained education campaign to develop the industry. Finance Minister Sri Mulyani Indrawati and foreign industry representatives support these recommendations and are searching for ways to implement them. This cable uses the exchange rate of Rp 9090 per dollar. End Summary.

¶2. (U) Indonesia's insurance sector pre-dates independence in 1945 when most insurance companies were foreign-owned including some founded by the Dutch. Asuransi Jiwa Bersama Bumiputera (or Bumiputera 1912 for short), one of the largest, was created as a mutual insurance company by a group of teachers in 1912 and remains Indonesia's only mutual insurance company. As of December 2005, there were 152 insurance companies in Indonesia, comprising 51 life insurers and 97 non-life insurers.

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Table 1: Insurance Companies, 2005

| | |
|---|---|
| Life, State-Owned | 1 |
| Life, Private | 34 |
| Life, Joint-Venture | 16 |
| Non-Life, State-Owned | 3 |
| Non-Life, Private | 75 |
| Non-Life, Joint-Venture | 19 |
| Re-insurance | 4 |
| Total: | 152 |

¶3. (U) Despite the considerable number of firms, the sector is small and concentrated. In 2005, insurance sector assets were equivalent to 2.8% of GDP and 4.1% of total financial sector assets. Approximately 60% of these assets are concentrated in the ten largest companies, while the ten smallest ones account for less than 1% of the market.

Table 2: Assets and Liabilities - Overview

| | Assets (in Rp trillion) | Liabilities (in Rp trillion) |
|---|---|---|
| Life | 53.9 | 46.4 |
| Non-life & Reinsurance | 22.4 | 5.0 |
| TOTAL | 76.3 | 51.4 |
| TOTAL $billion | $8.4 | $5.7 |



Source: Ministry of Finance, 2005 data.

¶4. (U) A few players dominate both the life and the non-life sectors. In the life sector, the top five companies have 53% of market assets (see Table 3). In the non-life sector the top five companies have 43% of the market by assets (See Table 4).

Table 3: Assets and Liabilities (Life)

| | Assets as of 2005 (in Rp trillion) | Liabilities (in Rp trillion) |
|---|---|---|
| State-owned: | | |
| Jiwasraya | 3.7 | 3.3 |
| Private: | | |
| Bumiputera 1912 | 9.7 | 9.6 |
| Sequis Life | 2.8 | 2.4 |
| Panin Life | 2.6 | 0.8 |
| Indolife Pensiontama | 2.2 | 1.8 |
| Remaining 30 | 6.7 | 5.4 |
| Subtotal | 23.9 | 20.0 |
| Joint Venture: | | |
| AIG Life | 6.7 | 5.6 |
| Manulife | 4.7 | 4.3 |
| Prudential | 4.1 | 3.5 |
| AIA Indonesia | 3.6 | 3.2 |
| Remaining 14 | 7.3 | 6.5 |
| Subtotal | 26.3 | 23.1 |
| TOTAL | 53.9 | 46.4 |
| TOTAL $ billion | $5.9 | $5.1 |

| Table 4: Assets and Liabilities (Non-Life) | | |
|---|---|---|
| | Assets (in Rp trillion) | Liabilities |
| State-owned: | | |
| Jasindo | 1.5 | 1.0 |
| Kredit Indonesia | 0.9 | 0.1 |
| Ekspor Indonesia | 0.6 | 0.1 |
| Subtotal | 2.9 | 1.2 |
| Private: | | |
| Panin | 2.2 | 0.1 |
| Tugu Pratama | 2.1 | 0.6 |
| Astra Buana | 2.0 | 1.4 |
| ACA | 1.3 | 0.5 |
| Remaining 71 | 7.4 | 4.1 |
| Subtotal | 15.0 | 6.7 |
| Subtotal Joint Venture | 3.3 | 1.6 |
| TOTAL | 21.2 | 9.5 |
| TOTAL $ billion | $2.3 | $1.0 |

Source: Ministry of Finance, 2005.



## Low Level of Insurance Penetration

¶5. (U) In addition to a very low level of social security, insurance penetration in Indonesia is small. Reasons for this include Indonesia's low per capita income, a lack of public understanding of insurance products, and a traditional cultural reliance on the extended family for financial support. Finance Minister Mulyani commented at a seminar in 2006, "My mother would say, 'Why do I need a pension or insurance? I have six children.'" Mulyani doubted the current generation of young people would relay on family in the same way, however. Hasbullah Thabrany, Chairman of the National Association of Health Insurance and Guarantee Management Experts (PAMJAKI) said that the low penetration rate is due to the lack of both education and interest. Despite several massive natural and manmade disasters in Indonesia from 2004-2006, few insurance companies were affected since so few people carry disaster or property insurance.

Table 5: Insurance Penetration 2005

| Country | Insurance Premiums (In $ Billions) | %GDP |
|---|---|---|
| Indonesia | 3.8 | 1.4 |
| Malaysia | 5.6 | 5.4 |
| Thailand | 4.9 | 3.5 |
| ASEAN | 24.3 | 3.4 |
| Australia | 40.4 | 8.0 |
| Canada | 59.2 | 6.8 |
| Japan | 479.1 | 10.8 |
| OECD | 2,709.8 | 9.0 |

Source: Indonesian Capital Markets and Non-Bank Financial Institutions Supervisory Agency; Swiss RE; OECD.

## Competition Growing Domestically

¶6. (U) Despite weak enforcement and regulation, competition in the insurance sector is getting stiffer. The World Bank estimates that from 2000-05, assets and premiums in the life sector almost tripled. In the non-life sector, assets increased about 75% and premiums by about 90% over the same period. The World Bank projects premiums could grow another 15-20% if GDP growth meets the GOI's projections of around 6% in 2007. As in the banking business, with relatively few new industrial customers, many insurance companies are targeting property-owning wage earners with consumer products, competing by offering low premium rates. An executive at a general insurance company told us vehicle insurance premiums are sometimes discounted by as much as 50%. However, the tight competition for a limited customer base has translated into low premium growth over the last couple of years. One international consultant told us "the last thing you want is rapid growth in a sector which is in weak financial condition and weakly regulated."

Weak Regulation and Enforcement
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¶7. (U) The Capital Markets and Financial Institutions Supervisory Agency (BAPEPAM-LK), an agency under the Ministry of Finance, is responsible for regulating and supervising the insurance sector. However, the agency operates under a weak legal framework, the Insurance Law of 1992, which established prudential regulations while at the same time muddying responsibility for resolving insolvent companies. The GOI took a major step in 1999 by launching Regulation No. 63/1999 which significantly increased the minimum paid-up capital requirements from Rp 3 billion ($330,000) to Rp 100 billion ($11 million) (Rp 200 billion or $22 million for re-insurance). However, existing ones were "grandfathered" under



the previous, lower capital requirement.

¶8. (SBU) According to many insurance industry insiders, years of weak regulation and indifferent supervision have left Indonesia with a number of insolvent domestic companies that may present a serious risk to the sector. Numerous small insurers are under-capitalized and unlikely to withstand stiffer market competition in the future. While stricter capital requirements have been in place since 1999, and the MOF has withdrawn the licenses of some small companies, none have been closed. Insolvent insurers with licenses revoked, continue to issue policies without penalty. An industry contact told us that a bank certificate of deposit was sometimes used to show the regulator that the insurer had the required minimum capital, then cashed after the business approval was received. A lengthy, 7.5 year audit cycle has allowed some insurers to operate with very little scrutiny. "There is a lot of fiction in the reported numbers," an industry contact noted. "It is pretty common knowledge that most companies keep two sets of books." There is no requirement for insurance companies to be rated, and ratings agency Pefindo rates less than ten domestic insurers.

Resistance to Reform Among Domestic Insurers
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¶9. (SBU) Not surprisingly, Indonesia's domestic insurance companies have proven resistant to reform. Lack of transparency about the ownership of many small insurers has left it difficult to gauge the true state of the sector. Some companies are owned or controlled by influential Indonesians, including members of Parliament, who may not be keen for regulatory reform. As the World Bank notes, "international experience indicates that costs of resolution increase consistently as a resolution decision is delayed."

¶10. (SBU) Another factor that has propped up an unreformed, domestic industry is excessive international reinsurance capacity. Industry sources told us that international reinsurers often offer local companies very attractive terms that reduce the need for them to follow best practices. The downside comes when there is a large event which small domestic insurers cannot afford to cover, forcing them to their international re-insurers. After the riots of 1998, for example, international re-insurers took many months to decide whether the riots were an "excluded event" or not. Although they

eventually paid, international joint venture companies paid claims quickly and without difficulty.

## Bumiputera 1912: Ticking Time Bomb?

¶11. (SBU) There is a consensus among expatriate insurance professionals that the financial condition of Bumiputera 1912 is one of the biggest risks facing Indonesia's insurance sector. Bumiputera had 13.4% of the life insurance market's gross premiums in 2005 (down from 38% in 1985), and remains the biggest life company in terms of customer base. It has approximately 9.7 million policyholders. The Ministry of Finance showed its assets of Rp 9.7 trillion ($1 billion) and liabilities of Rp 9.6 trillion ($1 billion) in 2005. However, a financial sector consultant and an industry contact we spoke with estimate it currently has $500 million more in contractual liabilities than it has in assets, and is, in reality, insolvent by both domestic and international standards. The MOF was aware of Bumiputera's financial woes as far back in 1999 when it enacted new capital requirements, and made an exception for "mutual life insurance companies." Bumiputera is Indonesia's only mutual life company. Then and now, Bumiputera's millions of middle class policyholders represent an important political force.

¶12. (SBU) "The GOI is losing sleep at night over Bumiputera," our industry contact told us, "it is a ticking time bomb." Another industry contact said "insurance companies should not be pay-as-you-go," noting that Bumiputera is simply paying claims from the premiums of new customers. The GOI is aware of Bumiputera's problems, and has quietly approached several international insurance



companies to purchase it. However, international insurers are reluctant to do so unless they are held harmless for Bumiputera's liabilities. Raden Pardede, the newly appointed chair of the Executive Forum of the Financial Sector Stability Forum, acknowledged that Bumiputera, "is absolutely a Ponzi scheme, but hopefully will survive for now. It urgently needs restructuring, a buyer or a rescue program." Despite the its weak condition, IMF Senior Resident Representative Steven Schwarz told us he did not think a collapse of Bumiputera would create contagion to the banking sector. "There are not close linkages to the banks," he concluded.

## Uneven Playing Field and Professional Gaps

¶13. (SBU) Regulations that protect weak companies at the expense of good ones represent another challenge for the sector. An example is a 2004 Ministry of Finance "Local Priority Treaty" that endorses domestic retention of premiums. The decree restricts the flow of premiums overseas to international reinsurers, and requires that 10% of the reinsurance business stay with domestically incorporated companies. International companies call this policy an example of the "good propping up the bad" and say it disregards the basic fiduciary responsibility of an insurance company.

¶14. (SBU) A lack of professional training of many insurance company employees also hampers the sector. While Indonesia has regulations mandating training and certification of insurance employees, the industry does not comply. Companies are also mandated to spend 5% of personnel budgets on training and education, but unlike in the banking industry, the MOF has not enforced this policy in the insurance sector. One organization is addressing the professional gap. The Institute of Risk Management and Insurance (STIMRA) in a joint initiative with the Ministries of Finance and Education along with donors, is now providing the first professional training for the insurance sector. STIMRA began a one-year accelerated program for individuals employed in the sector, and will graduate its first class of 32 in March 2007 with a Bachelor's in Insurance and Risk Management. Three and four-year diploma programs will see their first graduates in 2009 and 2010, and graduates are likely to receive multiple offers from an industry with a dearth of skilled employees. STIMRA will offer a certification program in underwriting personal auto, personal home-owners' and commercial property policies will, also a first for Indonesia.

## Slow Steps to Reform

¶15. (SBU) The Ministry of Finance is aware of problems in the insurance industry and is moving slowly to reform the sector. Responding to criticism of weak regulation and supervision, it is working on an "insurance industry blueprint". In May 2006, MOF appointed a dynamic, hard-working, new Director for Insurance, Isa Rachmarwata, an experienced actuary who trained in Canada. The Coordinating Ministry for the Economy tasked Rachmarwata with a report on the financial condition of domestic insurance companies by the end of 2006. Our MOF contacts tell us the report is complete, and awaiting review by the Finance Minister. However, a Ministry of Finance consultant cautioned us that the new Director's job is "massive." "He is starting to do what hasn't been done in twenty years."

¶16. (U) In July 2006, the GOI and Bank Indonesia launched a policy package aimed at strengthening the banking industry, non-bank institutions and capital markets to boost the economy. The package includes steps aimed at strengthening the capital structures of non-bank financial institutions, managing insolvent institutions and introducing good governance principles. However, international insurers remain concerned that there have been inadequate industry consultations in developing needed reforms. The five main policy actions in the plan are:

A) Resolution of insolvent insurance firms by creation of a clear exit strategy.



B) Improving the quality and effectiveness of insurance industry regulation and supervision through amendments and new guidelines.

C) Protection of policy holders via a mediation agency.

D) Improvement of the quality of director's and commissioners in the insurance industry through fit-and-proper test of directors and commissioners of insurance companies (10% completed by the end of 2006).

E) Improving tax treatment of the insurance industry by recognition that claims paid by life insurers are tax deductible.

¶17. (U) The GOI's reform priorities largely track with World Bank recommendations for reforming the sector. The Bank has put forward three major reform priorities to the Ministry of Finance:

- Rationalize the industry including resolving weak and bankrupt firms.

- Improve the enforcement and regulatory capacity of the Ministry of Finance as supervisory authority.

- A sustained education campaign to develop and promote the industry.

## Legacy of Manulife and Prudential Cases

¶18. (SBU) The 2002 Manulife case and 2004 Prudential case continue to cast a shadow over foreign participation in the insurance sector. In the former case, the Commercial Court granted a bankruptcy petition against a local subsidiary of Canadian insurance firm Manulife Financial Corporation, even though the MOF declared the subsidiary fully solvent. The judges ruled Manulife Indonesia bankrupt for not paying a 1999 dividend, forcing the company to shut down operations for six days. The Supreme Court later overturned the ruling after facing strong protests from the international business community and the Canadian government. In a similar case two years later, a commercial court in Jakarta declared Prudential's local unit bankrupt after a former consultant to the company accused the insurer of not paying his fees. A court-appointed receiver ordered the London-based insurer to suspend its local operations.

The foreign business community heavily criticized this case as severely damaging to the investment climate.

¶19. (SBU) Industry and business representatives, working with the Ministry of Finance and Parliament, submitted an amendment to close the loophole in the bankruptcy law. In September 2004, Parliament passed Bankruptcy Law No. 37/2004, replacing Law No. 4/1998. The amended law requires prior approval by the Ministry of Finance before a court can declare an insurance firm bankrupt. It also specifies that only the Finance Minister can file a bankruptcy petition against insurance companies in commercial courts. (The attorney general and the central bank are the only bodies permitted to file petitions against banks.) Nevertheless, the judicial uncertainty revealed in these cases damaged the investment climate and spooked foreign companies. From 2000-2004, 14 international insurance companies in Indonesia closed their doors.

¶20. (SBU) Comment. The MOF appears to be beginning to address some of the insurance sector's problems with help from STIMRA, donors and the insurance associations. The World Bank told us that after delivering its recommendations for non-bank financial institutions publicly in January, it met for over five hours with Finance Minister Mulyani to discuss them in detail. International industry players are pushing for an independent "Blue Ribbon Commission" to look at the condition of the insurance industry, and believe the sector needs the same level of scrutiny that the banking sector received after the 1997-98 financial crisis. However, the challenges facing the sector are daunting, and resolving them may take years. Despite Bumiputera's troubled state, our contacts agree



this politically sensitive case must be managed carefully so as not to create a crisis of confidence. The MOF will also need to proceed carefully given powerful interests in domestic insurance companies. The good news is that Mulyani has shown, by her appointment of a new insurance director, her careful attention to World Bank and industry recommendations, and the inclusion of an insurance reform component in the financial sector reform package, that she is committed to improving the sector.

HEFFERN